United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

ORIGINAL
WITH PROOF
OF SERVICE

76-5028

UNITED STATES COURT OF APPEALS

for the

SECOND CIRCUIT

B

In the Matter of

UNISHOPS, INC.,

Debtor

P/S

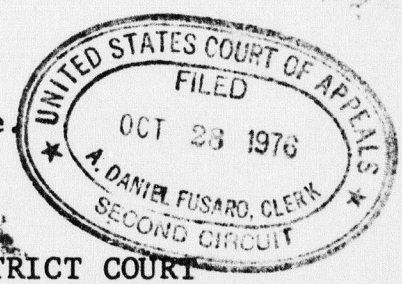
JEROME ZELIN,

Claimant-Appellant,

-against-

UNISHOPS, INC.,

Debtor-Appellee.



APPEAL FROM THE UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

APPELLANT'S BRIEF

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George Natanson, Esq.

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- -X

Appeal From An Order Of The United States District Court For The Southern District of New York.

APPELLANT'S BRIEF

Preliminary Statement

On November 30, 1973, the Debtor-Appellee ("Unishops") filed a petition for an arrangement under Chapter XI of the

Bankruptcy Act, in the United States District Court for the Southern District of New York (A-18 Par.6). It was appointed debtor-in-possession (A-18 Par.7).

Jerome Zelin, the Claimant-Appellant ("Zelin") was employed by Unishops at the time its petition was filed and had been so employed for more than eleven years (A-18 par.8, A-17 Par.2). His employment by Unishops was approved by a Court order (A-18 par.10). On July 16, 1974, Zelin was discharged(A-19 Par.11). Zelin then filed a proof of claim for severance pay of $100,000., due him under a written agreement with Unishops, asserting that it was an expense of administration (A-8). Unishops moved to reclassify Zelin's claim as a general claim (A-12, A-15). Bankruptcy Judge Babitt filed an opinion allowing the claim as an expense of administration (A-20) and entered an order to that effect dated September 4, 1975 (A-35). Unishops appealed to the District Court, where Hon. Thomas P. Griesa filed an opinion and order dated August 2, 1976, reversing Judge Babitt's order. Zelin's appeal is from Judge Griesa's order (A-46).

While the appeal to the District Court was pending, Natanson, Reich & Barrison were substituted as attorneys for Zelin in place of Aranow, Brodsky, Bohlinger, Benetar & Einhorn.

Unishops does not dispute the amount of Zelin's claim, but only its classification.

The Issue Presented

SHOULD ZELIN'S CLAIM BE ALLOWED AS AN EXPENSE OF ADMINISTRATION?

Statement Of The Case

Unishops is engaged in the operation of a chain of retail stores and departments. Zelin had first been employed by Unishops in or about 1962 (A-17 par.2). On March 19, 1973, Zelin was the chief operating officer of Unishops (A-10). On that date, he entered into an agreement, in writing, with Unishops (the "Agreement"), a true copy of which is attached to his proof of claim(A-10, A-17 Par. 1). The Agreement provides, in pertinent part, that if Zelin's employment is terminated "...at any time or for any reason other than..." his death or resignation, Unishops will pay to

him, in monthly installments over two years, a total of $100,000. It contains other provisions, not applicable here, authorizing him to resign, without loss of severance pay, if the nature or location of his employment should be materially changed.

On or about July 16, 1974, Unishops discharged Zelin (A-19 par.11). It is not disputed that he thereupon became entitled to payment of $100,000. under the Agreement. The time within which payment of that amount in installments would have been made has long since expired; and the installment arrangement has accordingly been disregarded by both parties.

Zelin filed his proof of claim for $100,000., asserting it to be payable as an expense of administration (A-8). Unishops thereafter made an omnibus motion to "expunge or reclassify claims"(A-I2). The Zelin claim is the last item listed in that part of the motion schedule appearing on page A-15. Unishops sought to reclassify it as a general claim.

The motion to reclassify, insofar as it related to the Zelin Claim,was submitted to Bankruptcy Judge Babitt

upon an agreed statement of facts (A-17). He filed an opinion (A-20) discussing in detail various contentions advanced by Unishops (some of which appear to have been abandoned since). He concluded that the Zelin claim should be allowed as an expense of administration (A-34). On September 4, 1975, he entered an order so allowing it.

Bankruptcy Judge Babitt's opinion held, inter alia, that Unishops, as a debtor-in-possession, was bound by the Agreement, since it had never been rejected by Court order as required by Section 313(1) of the Bankruptcy Act, regardless of the fact that the debtor-in-possession is a different entity from the debtor (A-28 - A-29); that the Agreement was assumed by Unishops, because it continued Zelin's employment for seven and one-half months until his discharge; and that since the Agreement was never rejected while it remained executory, the severance pay becoming due because of discharge during administration was an administration expense (A-30). With respect to Rule XI-3 of the Bankruptcy Rules for the Southern District, he held that it did not bar the

allowance of the claim, because, as established by this Court's decision in:

Straus-Duparquet v. Local No. 3,
386 F.2d 649 (2d Cir.1967),

the severance pay which became due under the Agreement was not wages, but damages and not the subject of an XI-3 order (A-30, A-31).

Upon appeal to the District Court, Judge Griesa reversed Bankruptcy Judge Babitt's order. He held, inter alia, that where an employment contract continues in effect after the commencement of Chapter XI proceedings and an employee is then discharged, severance pay is an expense of administration, citing (A-42):

Straus-Duparquet v. Local No. 3,
supra;

that an executory agreement does not "...automatically continue in effect..." because the debtor-in-possession is "...a new juridical entiry" (A-43); that there is a procedure

under the Bankruptcy Act for formal rejection of executory contracts (A-43); and that a debtor-in-possession is not bound by a pre-existing executory contract unless "it is 'assumed' either expressly or impliedly", citing (A-43) this Court's decisions in:

> Brotherhood of Railway v. REA Express, Inc., 523 F.2d 164, 170 (2d Cir. 1975)
>
> Shopmen's Local v. Kevin Steel Products, Inc., 519 F.2d 698, 704 (2d Cir. 1975)

Judge Griesa then held that Rule XI-3 of the local District Rules "clearly covers" severance pay, even if considered compensation for termination of employment, as held by this Court; that since the Agreement was not expressly covered in the XI-3 order, it was not enforceable and that severance pay agreements should also be subject to Rule XI-3 approval (A-45).

A careful reading of Judge Griesa's opinion makes it clear that the only basis for the reversal was his conclusion that the severance pay should not be allowed as an expense

of administration because it was not covered by the XI-3 order. This appears to be a new departure, not heretofore contemplated by XI-3 orders.

POINT I

THE AGREEMENT CONTINUED IN FULL FORCE UNTIL ZELIN WAS DISCHARGED

There was no real disagreement on this point in the lower courts. Judge Babitt's position needs no paraphrase from us. He wrote (A-28):

> "Unlike the statutory treatment in straight bankruptcy, Section 70(b), a debtor in possession may only reject an executory contract by affirmative action under Section 313(1) of the Act, 11 U.S.C. Section 713(1), read with Chapter XI Rule 11-53 or under Section 357(2) of the Act, 11 U.S.C.757(2). 8 Collier on Bankruptcy (14th ed.) Section 3.15(6). Unless so rejected, the contract continues in effect. Smith v. Hill, 317 F.2d 539 (9th Cir. 1963) citing 8 Collier on Bankruptcy, ibid. Clearly, then, the transformation of a debtor into a debtor in possession on the filing of the Chapter XI petition does not terminate executory contracts in effect prior to the petition. To hold, as the debtor insists, that all pre-petition contracts fall on the filing would render Section 313(1) meaningless and indeed, would run contrary to the realities. And not even recognition that the Chapter XI debtor in possession is 'not the same entity as the

pre-bankruptcy company', Shopmen's Local Union No. 455, et al. and N.L.R.B. v. Kevin Steel Products, Inc., _____F.2d _____ (2d Cir. July 24, 1975), (*), slipsheet opinion, p.5111, can comfort the debtor here, for it clearly 'assumed' the Zelin employment after it became debtor in possession until it was felt his services were needed no longer and he was let go."

(*) Since reported at: 519 F.2d 698

Judge Griesa agreed (A-42) that if a contract providing for severance pay continued in effect after filing of a Chapter XI proceeding and if the employee were discharged while it was pending, severance pay would be an expense of administration (A-42). He also held, however, in reliance on this Court's decisions in:

Brotherhood of Railway v. REA Express, Inc supra; and

Shopmen's Local v. Kevin Steel Products, Inc., supra,

that the debtor-in-possession is not bound by a pre-existing executory contract unless it is "assumed", either expressly or "impliedly" (A-43). He then apparently abandoned that

phase of the matter and proceeded to the discussion of Rule XI-3, which he considered decisive (A-43).

We submit that there is no question but that the Agreement remained in full force until Zelin was discharged; and that there is nothing in the two recent decisions of this Court cited by Judge Griesa which supports any contrary view. A review of the authorities relied on by Bankruptcy Judge Babitt (A-28) makes this clear.

Assumption of an agreement may be by express court order or may be implied from the facts. Rejection, however, cannot be implied. It can only be accomplished by a court order, pursuant to Section 313(1) of the Bankruptcy Act.

Section 3.15(6) of Collier on Bankruptcy (14th ed.) Volume 8, referred to by Bankruptcy Judge Babitt (A-28), reads as follows:

> "There is no such time limit in a case under Chapter XI. The failure to assume affirmatively an executory contract does not result at any time in a rejection of the contract. Whether the debtor is in possession, or whether there is a receiver or trustee, the contract can be rejected only by affirmative action under

Sec.313(1) and Chapter XI Rule 11-53 or Sec.357(2). Unless so rejected, the contract continues in effect". (emphasis supplied)

That section of Colliers was cited in:

Smith v. Hill
317 F.2d 539 (9th Cir. 1963,
at p.546, footnote 6.

The opinion is largely contained in the footnotes; but the relevant headnote reads as follows:

"In Chapter XI proceeding, failure to assume affirmatively an executory contract does not result at any time in rejection of contract, and whether debtor is in possession or whether there is a receiver or trustee, contract can be rejected only by affirmative action, and until so rejected, continues in effect. Bankr.Act,Sec.301 et seq., 11 U.S.C.A.Sec.701 et seq.".

An earlier case which reached the same result under former Section 77-B is:

Consolidated Gas v. United Railways,
85 F.2d 799 (4th Cir. 1936)

where the Court wrote (at page 805):

"Bankruptcy contemplates the sale of the bankrupt's property and a distribution of the proceeds to the creditor; and the intervention of bankruptcy constitutes a breach of an executory contract, if the trustee does not elect to assume its performance, and gives rise to a provable claim. Central Trust Co. v. Chicago Auditorium Ass'n, supra. Section 77B, on the other hand, does not contemplate the surrender and sale of the debtor's assets, but rather the transfer of the property, including executory contracts and leasehold estates not affirmatively rejected, to a reorganized body for the continuance of the business. An executory contract, therefore, remains in force in a proceeding under section 77B until it is rejected, and unless rejected, it passes with other property of the debtor to the reorganized corporation". (emphasis supplied)

If there is any decision which actually holds to the contrary or which would indicate that an executoy agreement did not remain in force so long as it was not rejected by the debtor, it has not yet turned up.

With due deference to Judge Griesa, we are unable to follow his reliance, for this point, upon the two recent decisions of this Court which he cited.

In:

Shopmen's Local v. Kevin Steel Products, Inc., supra,

Judge Feinberg stated the issue succinctly when he said,

at the opening of his opinion:

> "This case squarely presents to an appellate court, apparently for the first time, the question whether section 313(1) of the Bankruptcy Act allows rejection of a collective bargaining agreement as an executory contract. We conclude that the answer is yes, despite the position of the National Labor Relations Board that there is a direct conflict between the Bankruptcy Act and the National Labor Relations Act in which the Labor Act must prevail in order to preserve 'industrial peace'. "

The answer to that question cannot support Judge Griesa's conclusion. If the labor agreement in that case was not binding on the debtor-in-possession for lack of express assumption, it would not have required rejection; and the entire case would have been moot. The fact that a debtor-in-possession is a "new entity" is a concept which has been familiar since at least 1938. In effect, the debtor-in-possession becomes its own trustee. That, however, is a far cry from saying that its executory obligations disappear by some sea change.

Promptly after deciding the Shopmen's Local case, this Court was confronted with:

Brotherhood of Railway v. REA Express, Inc., supra.

The opening sentence of Judge Mansfield's opinion in that case was:

> "Once again we are called upon, within a matter of weeks, to determine whether a trustee or debtor-in-possession in bankruptcy under the Bankruptcy Act may, under Sec.313(1) of that Act, 11 U.S.C. Sec.713(1), disaffirm executory collective bargaining agreements entered into by the debtor".

The Court concluded that the collective bargaining agreement of REA Express, although subject to the Railway Labor Act, could be rejected under Section 313(1) of the Bankruptcy Act. Of interest here is Judge Mansfield's comment (at page 170) that the debtor-in-possession would not be bound by the collective bargaining agreement

> "...unless and until the contract should be assumed, either expressly or conforming to its terms without disaffirmance, In re Public Ledger, Inc. 161 F.2d 762,767 (3rd Circ. 1947)".

Judge Mansfield's comment applies with full force to this case. Unishops conformed to the Agreement without disaffiirmance. Although it discharged Zelin after seven and one-half months of his service in the Chapter XI proceeding, it never disaffirmed, questioned or rejected the Agreement.

The order of the Bankruptcy Judge, made in December 1974, almost five months after Zelin's discharge, was not an order of rejection, since by then the Agreement had long since ceased to be executory. It merely directed that the Agreement be deemed to have been terminated by the discharge. Implicit in that ruling is the finding that the Agreement continued in force until it was terminated (A19, par.13).

POINT II

ZELIN'S SEVERANCE PAY BECAME DUE BY REASON OF HIS DISCHARGE DURING ADMINISTRATION; AND IS THEREFORE PAYABLE AS AN EXPENSE OF ADMINISTRATION.

This issue was disposed of by this Court's opinion in:

Straus-Duparquet v. Local No. 3, 386 F.2d 649 (2nd Cir. 1967),

where Judge Hays wrote (page 651):

> "Severance pay was properly held to be an expense of administration. Severance pay is not earned from day to day and does not 'accrue' so that a proportionate part is payable under any

circumstances. After the period of eligibility is served, the full severance pay is due whenever termination of employment occurs. Severance pay is

> 'a form of compensation for the termination of the employment relation, for reasons other than the displaced employees' misconduct, primarily to alleviate the consequent need for economic readjustment but also to recompense him for certain losses attributable to the dismissal.'

Adams v. Jersey Central Power & Light Company, 21 N.J.8, 13-14, 120 A.2d 737,740 (1956).

Since severance pay is compensation for termination of employment and since the employment of these claimants was terminated as an incident of the administration of the bankrupt's estate, severance pay was an expense of administration and is entitled to priority as such an expense".

Judge Babitt quoted and followed that decision in holding, among other things, that Rule XI-3 did not bar the allowance of Zelin's claim as an expense of administration (A-31). Judge Griesa acknowledged the effect of that decision, writing (A-42):

> "Where such a contract continues in effect, and provides for severance pay, and where discharge of employees occurs during the pendency of Chapter XI proceedings, severance pay is considered an administration expense. Straus-Duparquet, Inc. v. Local Union No. 3, 386 F.2d 649 (2d Cir. 1967)."

The Straus-Duparquet decision, so far as we have been able to ascertain, has only been cited in one appellate decision:

In re Mammoth Mart, Inc.
536 F.2d 950 (1st Cir. 1976)

The issue in that case was stated by Chief Judge Coffin in the opening sentence of his opinion, as follows (page 952):

> "The sole issue in this appeal is whether a severance pay claim, which is determined by the length of a former employee's service with a bankrupt company and which arises from a discharge during a Chapter XI proceeding, is entitled to priority as a 'cost and expense of administration' under Sec.64(a)(1) of the Bankruptcy Act, 11 U.S.C.Sec.104(a)(1)".

The Court concluded that allowances for severance pay, as expenses of administration, which had previously been made, were adequate; and that since the amount of severance pay in that case was based upon the length of services rendered long prior to the proceedings, further payments could not be allowed.

Although the opinion makes an unfriendly comment on Straus-Duparquet (at page 955), the Court actually stated

a conclusion which fully supports both the holding in that case and our position here. Chief Judge Coffin wrote (at page 955):

> "It follows that whether a claim for severance pay based upon an unrejected contract with the debtor and arising from a chapter XI discharge will be entitled to Sec.64(a)(1) priority will depend upon the extent to which the consideration supporting the claim was supplied during the reorganization. If an employment contract provides that all discharged employees will receive severance pay equal to their salaries for a specified period, the consideration supporting the claim - being an employee in good standing at the time of the discharge - will have been supplied during the arrangement, and the former employee will be entitled to priority. See In re Public Ledger, supra, 161 F.2d at 769-71".
> (emphasis supplied)

That language precisely fits this case. Zelin, the discharged employee, was to receive a fixed amount of severance pay, unrelated to his length of service; he was an employee in good standing at the time of his discharge during the arrangement; and he is entitled to priority.

POINT III

RULE XI-3 IS NOT APPLICABLE TO SEVERANCE PAY.

The Rule reads as follows:

"Rule XI-3 -- Compensation to Debtor

No compensation shall be paid to the debtor, if an individual, or to the members of a copartnership, if a co-partnership, or to an officer, stock-holder or director of a corporation, if a corporation, from the time of the filing of the petition until con-firmation of the arrangement unless a prior order of the court shall have been obtained approving the employment and fixing the compensation".

The actual basis for Judge Griesa's decision is found toward the latter part of his opinion, where he wrote (at page A-44):

"This rule refers to officers' compensation in general, and clearly covers severance pay, whether such pay is thought to be compensation for employment or, in the words of the Second Circuit in the Strauss-Duparquet case, 'compen-sation for termination of employment.' Severance pay was unquestionably intended to be a form of compensation for Zelin as an officer of Unishops".

However, the flat statement that the rule "clearly" applies to severance pay, which was "unquestionably" intended as "compensation" appears to be a bootstrap conclusion, carrying no conviction.

The background of the Rule requires no detailed analysis. It was intended to govern the "compensation" paid to officers of a debtor-in-possession for services rendered during the proceeding. If the Court felt that the salary paid to the officer pre-filing was excessive, it could be reduced. The word "compensation", however, has been understood to mean precisely what it says, namely salaries paid for services rendered.

In this case, an order was entered approving Zelin's employment and fixing his salary at $100,000. a year (A-18 par.10). We remind the Court that the order was procured upon the application of the same debtor-in-possession (A-40), represented by the same counsel, which now alleges and who now contend that the order prepared and procured by them was insufficient to protect Zelin because it did not also approve his severance pay agreement. If anything is clear in this case, it is the fact that that claim is an afterthought.

If Judge Griesa's approach is correct, then Rule XI-3 orders would have to cover everything having any connection with employment. Presumably this will include not only compensation and severance pay, but length of term, hours and places of work, vacations, sick leave, stock options, cancellation agreements and any of the other numerous provisions that may be included in employment agreements. Certainly all of them have some bearing, however remote, upon what an employee receives. The Rule, however, is utterly silent on the subject of employment agreements. It says only that an order is to be obtained "approving the employment and fixing the compensation". That was done in this case. Nothing else was required.

This Court held, in Straus-Duparquet v. Local No. 3, supra, that severance pay was not compensation for services but that it was compensation "...for the termination of the employment relation..." (at page 651) and that therefore, since the employment was terminated as an incident of the administration, the severance pay was entitled to priority as an expense of administration. Bankruptcy Judge Babitt

followed that decision, when he said, with respect to Rule XI-3 (at page A-31):

> "The weakness in this argument is that severance pay is not compensation for employment but for the termination of employment; severance pay is not wages, but damages. As the court said in Straus-Deparquet, supra, at 651:
>
> > 'Severance pay is a form of compensation for the termination of the employment relation, for reasons other than the displaced employee's misconduct, primarily to alleviate the consequent need for economic readjustment but also to recompense him for certain losses attributable to the dismissal.'
>
> Since Local Rule XI-3 was not designed to include provisions for severance pay, no inference of rejection of the letter agreement is to be drawn from the silence on that issue in the order of December 7, 1973".

Judge Griesa's opinion quoted above, simply held, without analysis, that severance pay was covered by Rule XI-3, regardless of the distinction made by this Court in Straus-Duparquet.

The distinction between "compensation" and "severance pay" is not new. The following definitions appear in:

Ballentine's Law Dictionary
Third Edition, 1969

"severance pay. A payment made by an employer to an employee upon termination of the employment, otherwise known as dismissal compensation or separation wage.
See dismissal compensation"

"dismissal compensation. A payment made by an employer to an employee, in addition to wages or salary then owing by the employer to such employee, upon the termination of the employment, particularly where the employment is under a contract which entitles the employer to terminate the employment and discharge the employee at will. Anno: 147 ALR 151; 40 ALR2d 1044. Sometimes called separation wage; sometimes severance pay."

We respectfully submit that Judge Griesa's conclusion as to the effect of Rule XI-3 in this case, is unsupported by either reason or authority, and is wholly unwarranted. Rule XI-3 can only apply to compensation for services as such. It does not apply to a payment which is actually a measure of damages for the breach of an agreement in writing; and it

is stretching construction to impossible lengths to hold that so simple a rule requires full disclosure of all of the terms and conditions of an officer's employment.

Decisions asserted by Unishops below to equate severance pay with ordinary compensation,

Drysdale v. Commissioner
277 F.2d 413 (6th Cir. 1960)

Botchford v. Commissioner
81 F.2d 914 (9thCir. 1936)

are inapplicable here. In the Drysdale case, the issue was whether deferred compensation, held in bulk by a trustee for periodic payments, was taxable as income on the theory of constructive receipt. In the Botchford case, the issue was whether a bonus voted to an employee on retirement was a gift or taxable income.

If Rule XI-3 is to have a new meaning and application, it should be effected by an amendment to the Rule; and not by penalizing Zelin for the alleged failure of his employer and its counsel to procure an order nobody thought might be needed.

CONCLUSION

Unishops had available a very simple method of converting Zelin's severance pay into a general claim. All it had to do was to seek a Court order authorizing it to reject the Agreement before it discharged Zelin, while the Agreement was still executory. Its awakening, in December 1974, came five months too late.

Having failed to follow appropriate procedures available to it, Unishops now asks this Court to accomplish the same result it by a strained construction of Rule XI-3, which was never meant to apply here. That is not a process which should commend itself to a Bankruptcy Court, which is a court of equity.

Bank of Marin v. England
385 U.S. 99 (1966)

THE ORDER APPEALED FROM SHOULD BE REVERSED; AND THE ORDER OF THE BANKRUPTCY JUDGE ALLOWING ZELIN'S CLAIM AS AN EXPENSE OF ADMINISTRATION SHOULD BE AFFIRMED.

October 26th, 1976.

Respectfully submitted,

NATANSON, REICH & BARRISON
Attorneys for Claimant-Appellant
Jerome Zelin

George Natanson, Esq.,
of Counsel.

STATE OF NEW YORK)
COUNTY OF NEW YORK) ss.:

Kenneth E. Kennedy, being duly sworn, deposes and says that deponent is not a party to the action, is over 18 years of age and resides at 1171 Sterling Place Brooklyn N.Y. 11213.

That on the 27 day of OCTOBER, 1976, deponent personally served the within APPELLANT'S BRIEF upon the attorneys designated below who represent the indicated parties in this action and at the addresses below stated which are those that have been designated by said attorneys for that purpose.

By leaving 2 true copies of same with a duly authorized person at their designated office.

~~By depositing _____ true copies of same enclosed in a postpaid properly addressed wrapper, in the post office or official depository under the exclusive care and custody of the United Stated post office department within the State of New York.~~

Names of attorneys served, together with the names of the clients represented and the attorneys' designated addresses.

LEVIN + WEINTRAUB
ATTORNEYS FOR DEBTOR-APPELLEE
255 BROADWAY
NEW YORK, N.Y. 10007

Kenneth E. Kennedy

Sworn to before me this
27th day of October, 1976

Michael DeSantis

MICHAEL DeSANTIS
Notary Public, State of New York
No. 03-0930908
Qualified in Bronx County
Commission Expires March 30, 1977